No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD C. NOTEBAERT,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR RESPONDENTS

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CONSTITUTIONAL PROVISION INVOLVED

U.S. CONST. amend. VII provides:

> In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law.

STATEMENT OF THE CASE

The Second Consolidated Amended Class Action Complaint ("SAC") identifies, by description, 26 persons,[1] including 25 former Tellabs employees, with knowledge and information concerning the allegations of wrongdoing relevant to the core products at issue — the TITAN 5500 ("5500") and the TITAN 6500 ("6500"). The Seventh Circuit noted: "[M]any of the informants were in a position to provide reliable information whether Birck's and Notebaert's statements were false and material and whether Birck and Notebaert knew this to be the case." (Pet. App. 11a) The independent sources corroborate one another and are corroborated by other particularized facts in the SAC, creating a strong inference that petitioners knew of, or at the very least recklessly disregarded, the severe problems affecting the 5500 and 6500, which jeopardized the Company's overall performance and prospects.

Tellabs and Its Core Products

Tellabs is a global supplier of optical networking, broadband access, and voice-quality enhancement solutions to telecommunications carriers and internet service providers. (JA 94, ¶2) In 2000, optical networking systems accounted for approximately 64% of its sales. (JA 101, ¶30) 5500 — Tellabs' principal seller in this category — was the Company's

[1] A twenty-seventh source provided information only with respect to Tellabs' SALIX product, which is no longer at issue.

"flagship," according to Tellabs' 2000 10-K.[2] (*Id.*) According to Tellabs' 2000 Annual Report, one of a small handful of "major new products" that Tellabs "began selling" in 2000 was 6500. (JA 127, ¶93) The central importance of 5500 and 6500 to Tellabs' success compels a powerful inference that Tellabs and Notebaert, who, as CEO and President throughout the Class Period, ran the Company at the highest levels, knew about serious problems affecting those products.

Falling Demand for Tellabs' "Flagship" 5500

By mid-2000, well before the Class Period (December 11, 2000 through June 19, 2001), Tellabs' customers were experiencing severe business deterioration and consolidation. (JA 94-95, ¶¶3, 4) With full knowledge of this dramatic slowdown in the telecommunications and internet sectors, petitioners falsely reassured investors that Tellabs' key products were continuing to enjoy strong demand. Yet, demand for 5500 — Tellabs' "best seller" — was, in fact, slowing substantially. (JA 103-05, ¶¶34-45) Numerous independent confidential sources confirmed the drop in demand for 5500, identifying specific customers that significantly reduced their orders, including Verizon Communications, Inc. ("Verizon"); SBC Communications, Inc. ("SBC"); Lexcom; and Telcobuy.com — the Company's major customers and distributors.[3] (JA 103, 105, 111-13, ¶¶35, 37, 43, 67-71) The importance of Tellabs' relationships with such key customers as Verizon and SBC further supports a strong inference that petitioners were well aware of significant decreases in those customers' orders and improper sales practices affecting them. Moreover, the richly particularized complaint demonstrates:

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[2] Tellabs' 2000 Annual Report similarly identified 5500 systems as its "core products." (JA 101, ¶30)

[3] Sources confirmed that Verizon, which alone accounted for over 19% of net sales in 2000, was Tellabs' largest customer for 5500 in 2000 and 2001. (JA 102, ¶33) Tellabs' three largest distributors included Telcobuy.com and Lexcom. (*Id.*)

• According to a Tellabs installations supervisor, in late 2000, there was a roughly 25% reduction in 5500 orders from Verizon, Tellabs' largest customer. (JA 130, ¶35) A Tellabs operations manager reported that, in January 2001, Verizon orders declined by about 50%. (*Id.*) According to a Tellabs executive account manager and regional manager, during the fourth quarter 2000 and throughout 2001, Verizon failed to execute millions of dollars of projected 5500 orders. (JA 105, ¶43)

• According to a Tellabs customer manager, as early as November 2000 (before the Class Period), Tellabs' customers were not buying: "it got slower and slower." (JA 104, ¶41)

• According to a Tellabs business development manager, by early 2001, sales of Tellabs' products were declining. (JA 103, ¶38) A Tellabs sales director also recounted that 5500 sales declined noticeably by then. (JA 111, ¶65) According to a mid-level Tellabs distribution employee, by the beginning of the first quarter of 2001, Tellabs had no orders and distribution personnel were told to go home early. (JA 113, ¶72)

• According to a team project manager for a product distributor, Tellabs stopped taking parts used to manufacture its products by the beginning of 2001. (JA 105, ¶44)

• According to a Tellabs marketing manager, Tellabs had excess 5500s on hand in late 2000/early 2001 and had "tons" of excess 5500s, and other products, on hundreds of racks in a warehouse; some systems sat on the shelves for six months to a year. (JA 104-05, ¶¶42, 45)

• According to a Tellabs engineer who held various managerial positions and who viewed the reports in question, Tellabs' finance department's internal quarterly reports showed declining demand in the third and fourth quarters of 2000 for 5500 and other Tellabs products. According to a Tellabs market analyst, quarterly reports concerning the profitability of Tellabs' products — reports accessible on Tellabs' database system —

showed a decline in 5500 demand by March 2001.[4] (JA 104, 155, ¶¶40, 153(d))

• According to a Tellabs marketing strategy executive, a $100,000 study performed for Tellabs by Probe Research, an independent firm, completed in or about early 2001, confirmed a steep drop in the number of T1 circuits, the main source of demand for 5500 systems. (JA 103-04, ¶39) That study was consistent with Tellabs' finance department's internal quarterly reports, which reflected a decline in 5500 demand as early as the second half of 2000. (JA 104, 155, ¶¶40, 153(d))

• An internal report prepared by Tellabs' marketing strategy department accurately concluded that, because of the T1 decline, 5500 revenue would fall by about $400 million (a huge and extremely significant decline given that Tellabs had no other products to take up the shortfall). That report was discussed at marketing strategy meetings, and was widely circulated to at least 10 executives, including individuals who reported directly to senior management (*e.g.*, the head of marketing strategy, who reported directly to Tellabs' Chairman). (JA 104, ¶39) Tellabs' mergers and acquisitions group also gathered market data, and fed it to Tellabs senior executives. (JA 159, ¶169)

• Tellabs senior management was in direct contact with the Company's customers. For example, according to a business

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[4] Tellabs executives also were provided daily computer reports concerning product bookings and revenue. A high-level Tellabs sales executive related that top management reviewed those reports regularly. (JA 155, ¶153(e)) Tellabs sales personnel produced weekly sales projections. (JA 155, ¶153(f)) In addition, Tellabs management was kept apprised of customer purchases and buying plans to ensure compliance with federal regulations and FCC supplier diversity requirements. (JA 159, ¶168) Notebaert had daily calls with fellow executives to stay on top of everything, and had weekly revenue calls concerning how Tellabs would "make its numbers." (JA 156, ¶153(g)) Notebaert also communicated with employees at town hall meetings, worked closely with the sales teams, and received sales personnel briefings on product status. (JA 109, 154, 156, ¶¶60, 153(a), 154)

development manager, Tellabs' Senior Vice President of Business Operations attended quarterly meetings with senior persons at Verizon, AT&T, and other important Tellabs customers. Tellabs management therefore knew how much customers were buying and planning to buy. (JA 158, ¶164)

• According to a Tellabs materials manager, orders from every single 5500 customer declined throughout the Class Period. (JA 103, ¶37)

• According to a Tellabs sales manager, customers in Latin America were not buying 5500. (JA 103, ¶36)

6500 Development Problems

In contrast to petitioners' public statements, which portrayed the product as launched and being sold, 6500, one of the Company's most significant new products, was far behind schedule, failing lab tests, and not ready for release. According to confidential sources, senior management knew that 6500 was not ready and that it was failing evaluations, and, in fact, visited customers in connection with those failures. (JA 107, 111, 157, 159-60; ¶¶50, 53, 67, 159, 171) A high-level Tellabs sales executive confirmed that Notebaert, and other senior executives, knew about 6500 problems.[5] (JA 107-08, 159-60, ¶¶53, 171-72)

• The high-level Tellabs sales executive also related that 6500 was almost two years late to market; its slow development was evident from 1998 through 2001. Customers that evaluated 6500 in their labs realized it "was not even close to being ready." Due to the delay, Tellabs lost approximately $50 million to $60 million of sales, and lost business to Alcatel. (JA 107-08, 159-60, ¶¶52-53, 171)

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[5] Although the sales executive left Tellabs shortly before the Class Period, he had worked at the Company for many years while 6500 was being developed (JA 91) and therefore clearly was in a position to know about 6500 development problems and what Notebaert knew about them.

• A Tellabs marketing manager confirmed that 6500 was failing customer evaluations. Tellabs' Senior Vice President of Product Development made numerous visits to customers regarding failed evaluations. (JA 107, ¶50)

• According to another high-level Tellabs sales executive, by October 2001, four months after the Class Period, there had been very few trials of 6500. (JA 106, ¶48) That is corroborated by a Tellabs distribution employee, who related that Tellabs did not make actual sales of 6500 or even have the product in its warehouse until after mid-September 2001. (*Id.*)

• According to a Tellabs project manager, even two months after the Class Period ended, 6500 still was not released. A Tellabs consultant also confirmed that 6500 was not approved by the Regional Bell Operating Companies. (JA 106, ¶48)

• According to a Tellabs senior business manager, at least since September 2000, Sprint network traffic, and hence demand for 6500, was dropping. (JA 106, ¶49)

• According to a Tellabs executive account manager, Tellabs was having difficulties testing 6500 and, in fourth quarter 2000 and first quarter 2001, Tellabs product managers were working to fix its defects and hoped to release the product in first quarter 2002, many months after the Class Period ended. (JA 107, ¶51)

• According to a former Tellabs marketing strategy executive, customers thought 6500 took too much space in comparison to its bandwidth capacity. Customers explained that competitor Ciena's product provided more bandwidth. Tellabs repeatedly attempted, without success, to sell its 6500 to major customers Verizon, BellSouth, and SBC. (JA 106, ¶47)

• Tellabs management received weekly and monthly reports concerning product development status. Tellabs sales personnel wrote weekly reports concerning sales projections and field trials, as well as customer maintenance reports, which updated trial status. (JA 155, ¶153(f))

Defendants' Misrepresentations Concerning 5500 and 6500

Despite their awareness of serious problems with 5500 and 6500, Tellabs, including Notebaert, made a series of materially false and misleading statements that inaccurately assured the market that 5500 demand remained strong and that 6500 was ready, and thereby artificially inflated Tellabs' stock price throughout the Class Period. The Seventh Circuit found the following actionable:

- Tellabs' December 11, 2000 press release: "The TITAN 6500 system is available now." (JA 113, ¶73)

- In Tellabs' 2000 Annual Report (issued February 14, 2001), Notebaert responded to the "frequently asked question" "Your core business is built on the TITAN 5500 — are you worried that this product has peaked?": "No . . . it's still going strong." (JA 126, ¶91)

- During a conference call on March 8, 2001, in response to an analyst's inquiry whether Tellabs was experiencing "any weakness there at all" as to 5500, Notebaert stated: "No, we're not. We're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance." (JA 132, ¶102)

- Notebaert also represented during the March 8 analyst conference call: "Interest in and demand for the 6500 continues to grow. . . . We continue to ship . . . 6500 through the first quarter. We are satisfying very strong demand and growing customer demand." (JA 131, ¶100)

- During an April 6, 2001 conference call, Notebaert told analysts: "[E]verything we hear from the customers indicates that our [end] user demand for services continues to grow."[6] (JA 137, ¶114)

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[6] Petitioners' bald assertion (Pet. Br. 8 n.5) that Notebaert's statement clearly refers to customers of Tellabs' customers, whose demand was continuing to grow, is entirely unsupported by the record and is an improper attempt to present factual issues for resolution at the pleading stage.

• During the same call, responding to a question whether Tellabs was still on track to recognize 6500 revenue in the second quarter, Notebaert again claimed: "the 6500 is showing strength . . . we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong. . . ." (JA 138, ¶117)

Petitioners' Unfounded Representations Concerning Tellabs' 2001 Performance

In addition, petitioners made projections for 2001 that had no reasonable basis given the lack of demand and production delays. Thus, through at least March 2001, Tellabs, including Notebaert, repeatedly falsely assured the market that it expected 30% growth in revenues and earnings for 2001.[7] (JA 114-16, ¶¶76-77; JA 120-22, ¶85; JA 130-31, ¶99; JA 131, ¶100)

Even after Tellabs modified its guidance in March and April 2001, in the face of disappointing first quarter results, petitioners continued to make overstated revenue projections and to reassure the public about the Company's prospects notwithstanding what petitioners knew about collapsing demand.

Thus, on March 7, 2001, Tellabs reduced first quarter guidance slightly, but simultaneously continued to assure investors, without a reasonable basis for doing so, that "[g]rowth in Tellabs' core optical networking business [*i.e.*, the 5500] remains strong" and that it "expects to recognize TITAN 6500 system revenues in the second quarter." Notebaert stated: "Given the strong acceptance of the new TITAN 6500, we continue to target 30 percent growth in revenue and earnings for the year." (JA 15 & 130, ¶99; *see also* JA 20 & 131-32, ¶¶100-103) When an analyst inquired about Tellabs' reaction to certain competitors' lowered expectations during a March 8, 2001 conference call, Notebaert, with considerable contrary knowledge, responded:

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[7] Tellabs' 2000 10-K, filed March 29, 2001, which Notebaert signed, represented that the Company was "on track to meet its objective of $6 billion in annual revenues by the year 2003." (JA 133, ¶107)

"we haven't gotten any indication, I haven't gotten any indication from any of our major clients, major customers, of a downturn in the segment we're in." (JA 132, ¶103)

On April 6, 2001, with the release of actual first quarter 2001 results imminent, Tellabs reduced further its projection for the quarter, but did not modify its guidance for the full year. (JA 31-42 & 137-39, ¶¶113-18) At the same time, petitioners again represented falsely that demand "continues to grow" (JA 34 & 137, ¶114) and that "the 6500 is showing strength . . . The demand is very strong."[8] (JA 37 & 138, ¶117)

Then, on April 18, 2001, the Company again lowered its guidance but, notwithstanding what petitioners knew about falling demand for the Company's core products, still projected full-year 2001 revenues within the range of $3.6 billion to $3.7 billion, a very substantial increase over 2000.[9] (JA 43-73 & 140-141, 147-48, ¶¶121, 142)

Thus, far from negating any inference of wrongdoing, petitioners continued to misrepresent Tellabs' prospects, as the SAC clearly alleges. (JA 132, 139, 141, ¶¶104 [March 7, 2001], 119 [April 6, 2001], 122 [April 18, 2001])

Petitioners' assertion (Pet. Br. 5, 47) that Tellabs' first quarter 2001 reported revenues increased by 21% over the previous year evidencing continued growth is misleading.[10]

[8] Notebaert also gave false assurances that there was only a temporary deferral of 5500 orders: "The good news there is that the orders weren't cancelled. It was just do it after the end of the quarter." (JA 37 & 138-39, ¶¶116, 119(b))

[9] For 2001, Tellabs ultimately reported net sales of less than $2.2 billion and a net loss of $182 million — a decline from 2000 of more than 35% in net sales and about 125% in net earnings. (JA 147-48, ¶142)

[10] In fact, first quarter 2001 net earnings were about $123 million. First quarter 2000 earnings *before the cumulative effect of a change in accounting principle* were virtually the same — about $121 million. (JA 47) Revenues fell by more than 24% from the fourth quarter 2000 to the first quarter 2001. (JA 118, 141, ¶¶81, 123(a))

Tellabs' 2000 10-K states that product revenue is recognized only "when all significant contractual obligations have been met, including the terms of the shipment, and collection of the resulting receivable is reasonably assured." *See* Defs.' App. of Materials Cited in the Mem. in Support of Defs.' Mot. to Dismiss, Tab 7 at 122-23. Accordingly, a decline in demand would affect revenues on a delayed basis.[11] Therefore, it is apparent that the dramatic drop in sales for the second quarter 2001 was the result of earlier reductions in orders, which is consistent with the SAC.

Channel Stuffing, Backdated Sales, and Other Deceptive Devices to Hide Falling Demand

To create a false picture of robust demand, petitioners engaged in numerous covert deceptive practices, including channel stuffing (JA 110-13, ¶¶62-71); over-inventorying, *i.e.*, jamming distributors with unsellable product (JA 111-13, ¶¶66-69, 71); writing phony purchase orders and delivering products customers had not ordered (JA 110-12, ¶¶63, 68); and backdating sales (JA 112, ¶70). Such practices falsely inflated Tellabs' fourth quarter 2000 results. (JA 122, ¶86(a)) A senior Tellabs business manager reported that management approved channel stuffing, and that Notebaert had direct involvement with and knew about the channel stuffing, which a high-level sales executive confirmed. (JA 111, 156-57, ¶¶67, 156)

• According to the same sales executive, Tellabs employees *fabricated* purchase orders and Tellabs' Verizon team used channel stuffing as a strategy. (JA 110, ¶63) Petitioners' channel-stuffing sales practices were so egregious Verizon's Chairman complained to Tellabs. (JA 112, ¶71)

• The senior business manager related that the magnitude of Tellabs' channel stuffing of 5500 in late December 2000 was "extraordinary" (JA 111, ¶64); that channel stuffing in December

[11] On March 8, 2001, Notebaert explained with regard to 5500: "We're in the process of installing ... a large number of frames that we shipped in the fourth quarter..." (JA 132, ¶102)

2000 involving SBC alone amounted to roughly $20 million; that Telcobuy.com and Verizon also were victimized by the channel stuffing; that Tellabs paid VARs[12], including Telcobuy.com, a certain percentage, 5% or 10%, to hold inventory, an abnormal practice in the industry; that Telcobuy.com wanted to return the product because it realized it could not sell it to SBC and that Tellabs had jammed Telcobuy.com; and that approximately $10 million to $15 million of inventory came back in 2001 (JA 111, ¶67).

• A Tellabs customer service accounts representative recounted that Tellabs sent customers unwanted product (especially 5500); that customers returned 5500 merchandise as soon as it showed up; that, although customer sites often were not ready, Tellabs delivered product anyway to make its revenue numbers; that he processed millions of dollars of returns, mostly 5500s; that returns were so heavy during early 2001 extra storage space had to be leased; that returns in the first three months of 2001 were in the millions of dollars; and that Verizon and Telcobuy.com were heavily returning product. (JA 111-12, ¶68)

• A Tellabs marketing manager related that Tellabs definitely channel stuffed and loaded up distributors "big and fat" at the end of the fourth quarter 2000 (especially in December), and that distributors were upset and later returned the product. (JA 111, ¶66)

• Another Tellabs marketing manager related that Tellabs got "creative" to meet fourth quarter 2000 and early 2001 investor expectations, including offering discounts and other incentives (not disclosed to the investing public), and shipping to distributors (including shipping 5500s to Lexcom in early 2001) without the ultimate customer's agreement to purchase,

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[12] Value added resellers ("VARs") are third parties that work with Tellabs to handle customer services, including engineering site surveys, installations, and testing services, and also distribute Tellabs' products. (JA 93)

as is customary, which resulted in returns the subsequent quarter. (JA 112, ¶69)

• According to the same marketing manager, to meet earnings expectations, Tellabs *backdated* sales for the 5500 — pulling sales to larger customers from the first quarter 2001 into the fourth quarter 2000. (JA 112, ¶70)

The deliberate nature of channel stuffing, sales backdating, and other deceptive practices also creates a strong inference of petitioners' knowledge. Tellabs' undisclosed efforts to accelerate sales by channel stuffing hardly can be viewed as innocent in light of the SAC's allegations that employees fabricated purchase orders (JA 110, ¶63); that Tellabs sent customers unwanted 5500s (JA 111-12, ¶68); that Tellabs backdated sales (JA 112, ¶70); and that Verizon's Chairman even called Tellabs to complain about channel stuffing (JA 112, ¶71).

Petitioners' self-serving speculation that Notebaert's participation in channel stuffing might only have involved fashioning customer discounts[13] has no record support. In any event, innocent or not, such *undisclosed* discounts, and other deliberate practices intended to inflate sales, are strong confirmation of weakening demand by the fourth quarter of 2000 and petitioners', including Notebaert's, awareness thereof.

Tellabs' June 19, 2001 Announcement

After trading closed on June 19, 2001, the Class Period's last day, Tellabs, having known the truth for months, issued a press release dramatically revising its second quarter guidance, reducing projected revenues, by approximately $300 million, to $500 million and projected earnings per share from $.29 to breakeven (before restructuring and other charges). Contrary to previous assurances that the telecommunications industry slowdown was not affecting Tellabs, the Company

[13] The SAC alleges that the incentives Tellabs offered, which were not disclosed to the investing public, were excessive, unusual, and departed from ordinary business practices. (JA 110, ¶62; *see also* JA 111-13, ¶¶67, 71)

acknowledged: "The dramatic changes affecting the landscape of the telecommunications marketplace have continued to impact Tellabs." (JA 144, ¶131)

During a subsequent analyst conference call, Tellabs attributed the severe revenue shortfall to a massive reduction in 5500 sales. (JA 145, ¶132) Further confirming the severity of Tellabs' problems, Notebaert admitted that the revenue collapse affected Tellabs' business "across the board." (JA 145, ¶133)

A June 19, 2001 article titled "Tellabs Plays Mini-Nortel with Steep Shortfall" appearing in TheStreet.com noted: "While it was not a total surprise on Wall Street that Tellabs was having a bad quarter, the size of its shortfall came as a big shock. 'Mind-numbing,' as one New York hedge fund manager put it." (JA 146, ¶136)

The next day, June 20, the trading price of Tellabs common stock fell $5.16 per share, or more than 24% (the greatest percentage decline in the history of Tellabs stock), on extraordinary volume of almost 36 million shares (five times the average daily volume during the Class Period). (JA 145-46, ¶¶135, 137) The price of Tellabs stock has never recovered. (JA 146, ¶139)

Notwithstanding their unqualified assurances to investors as late as March 2001 that 5500 was "continu[ing] to maintain its growth rate" and was "still experiencing strong acceptance," and that Tellabs continued to expect 30% growth in revenues and earnings for 2001, petitioners ultimately admitted they had been well aware, by at least "early ... 2001," that demand was falling dramatically. Corroborating other facts pleaded in the SAC showing early declining demand, Notebaert's post-Class Period letter to shareholders in the 2001 Annual Report admitted: "*Early in 2001, as our customers reduced capital spending and expressed caution about the future, Tellabs began a deep process of self-examination.*"[14] (JA 147, 160; ¶¶141, 172)

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[14] Throughout, emphasis is indicated by italics and, unless stated otherwise, is added in quotations.

The Annual Report also revealed that, in April 2001, Tellabs had begun a series of layoffs, ultimately reducing its workforce by about 27%. Tellabs closed manufacturing plants in Ireland and Texas, consolidated product development and other functions from 30 facilities into 20, and cut expenses dramatically. (JA 147, 159, ¶¶141, 170) It is a strong inference that the admitted-to "self-examination" that led to these moves and the planning of such dramatic cuts began at least earlier that year.[15]

Diametrically opposed to all of Tellabs' Class Period public assurances of substantial, continued growth, for the second quarter 2001, Tellabs ultimately reported net sales attributable to products of only $407,701,000 and a net loss of $174,702,000 — a drop from the second quarter 2000 of more than 43% in net sales and more than 211% in net earnings. For the full year 2001, Tellabs reported net sales of $2,199,700,000 and a net loss of $182,000,000 as compared to net sales of $3,387,400,000 and net earnings of $730,800,000 for 2000 — a decline of more than 35% in net sales and about 125% in net earnings. Further confirming the severity of Tellabs' problems, the Company reported a net loss of $313,100,000 for 2002. (JA 147-48, ¶142)

The sheer magnitude of the Company's problems, and all the other particularized facts in the SAC, judged in their totality, as they should be, support an overwhelming inference of Tellabs' and Notebaert's scienter that meets any rational interpretation of the statutory words "strong inference."

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[15] According to a Tellabs project manager, by March 2001, information circulated throughout the Company that capital expenditures would be cut because of falling sales. (JA 159, ¶170) Tellabs discontinued receiving production parts in early 2001. (JA 105, ¶44) Inventories piled up in late 2000/early 2001. (JA 104-05, ¶¶42, 45)

SUMMARY OF ARGUMENT

The Private Securities Litigation Reform Act of 1995 ("PSLRA") reaffirms Congress' longstanding and firm commitment to protect investors and simultaneously establishes a procedural regime that allows meritorious cases to proceed, abates frivolous ones, and promotes uniform application of the pleading requirements. In construing the PSLRA's strong inference requirement, this Court should be mindful of these policies.

This Court has held that securities actions are subject to the "preponderance of the evidence" standard at summary judgment and trial and should adopt a pleading standard consistent with that burden of proof. The PSLRA's language makes clear that a plaintiff can satisfy the strong inference standard by pleading particularized allegations that support a reasonable conclusion that, more likely than not, defendants acted with scienter. The standard on a motion to dismiss should not be more burdensome for a plaintiff than at summary judgment or trial.

The SAC sets forth many particularized facts indicating that petitioners acted with scienter. Detailed factual allegations based on information provided by 26 knowledgeable confidential sources and respondents' investigation demonstrate that Tellabs and Notebaert knew about the serious problems affecting sales of its most important products. The SAC further particularizes petitioners' actual knowledge of reduced demand and their resort to several nefarious practices to create a false picture of continuing demand. The Seventh Circuit faithfully articulated Congress' intent and properly applied the PSLRA pleading standard by examining all the complaint's allegations to determine whether a reasonable person could be convinced that a strong inference of scienter had been shown.

Congress did not intend to abolish the long-standing principle that, on a pleading motion, a plaintiff is entitled to have the complaint construed in its favor. Nor did Congress

authorize courts to weigh conflicting inferences put forth by defendants or to speculate about non-culpable explanations. Rather, the statute directs courts to determine whether there is a strong inference for *plaintiff*, not the defendant.

Congress adopted the strong inference standard from Second Circuit case law – "the most stringent pleading standard" at the time. That court's formulations did not allow district courts to weigh competing inferences or speculate as to innocent explanations for defendants' conduct. Since the PSLRA's enactment, most courts of appeal have adopted the same view of the strong inference standard, and do not weigh inferences. This Court should validate that practice.

Petitioners ask the Court to ignore the PSLRA's actual language and fabricate an impossible-to-meet heightened pleading burden that obliges a plaintiff to provide sufficient evidentiary detail to foreclose any possibility that the defendant's intent was not fraudulent. Such a requirement has no basis in more than a decade of case law applying the PSLRA, and is at odds with the established principle that a plaintiff is not required to plead detailed evidence or to prove the merits of its case in the complaint. The variant super-heightened pleading standards conjured up by petitioners and supporting *amici* are very likely to throw out the meritorious wheat along with the chaff. The PSLRA was never intended to leave the securities marketplace so vulnerable to malfeasance.

This Court has long held that the Seventh Amendment jury trial right is violated when the jury's role as fact-finder is interfered with or obstructed. Any interpretation of the PSLRA's standard requiring more than an inference strong enough to support a reasonable jury's finding that the defendant acted with scienter violates the Constitution's jury trial guarantee. Whether a complaint's allegations support a finding of scienter is a factual matter for the jury, unless the district court can conclude as a matter of law that no reasonable person could find that the defendant acted with the prohibited state of mind.

This Court should not be swayed by the outdated pre-PSLRA data relied on by petitioners and supporting *amici* or by the melange of extra-record unverified data and self-serving commentary they promote, hoping that this Court will legislate an extreme pleading standard. The PSLRA has had a major impact on securities litigation: the dismissal rate has *more than doubled* in the last few years, a large percentage of cases are effectively being led by competent and involved institutional investors, and, most recently, there has been a decline in filings. The complaint that private securities actions imperil the United States' competitive position in the global marketplace is largely unfounded, particularly given the actual data showing that our financial markets are thriving. The PSLRA has realized Congress' desire to curtail meritless securities litigation. But, like sharks scenting blood in the water, an array of corporate interests has mobilized in an attempt to administer a coup de grace to private securities enforcement by convincing this Court to raise the pleading standard to unprecedented heights.

ARGUMENT

I. ON A MOTION TO DISMISS COURTS SHOULD GIVE PLAINTIFFS THE BENEFIT OF ALL REASONABLE INFERENCES, AND SHOULD NOT WEIGH COMPETING INFERENCES OR POSSIBLE EXCULPATORY EXPLANATIONS

A. The PSLRA Does Not Abolish The Long-Standing Principles Governing Motions To Dismiss

Under the pleading regime long in effect: "The issue is not whether a plaintiff will ultimately prevail but whether a claimant is entitled to offer evidence to support his claims," and "the allegations of the complaint should be construed favorably to the pleader." *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974), *overruled on other grounds*, *Davis v. Scherer*, 468 U.S. 183 (1984). Nothing in the PSLRA abolishes those principles, amends Rule 12(b)(6), or terminates the canons that a plaintiff need not plead detailed evidence (*e.g.*, *Conley v. Gibson*, 355

U.S. 41, 47 (1957)), is not required to plead facts exclusively in defendants' possession (*e.g.*, *In re Rockefeller Center Props., Inc. Secs. Litig.*, 311 F.3d 198, 216 (3d Cir. 2002)), and is entitled to the benefit of all reasonable inferences in plaintiff's favor (*e.g.*, *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 254 (1986); *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000)).[16] These precepts can be traced back to Chief Justice Marshall's statement 200 years ago that "[t]he party demurring admits the truth of the testimony to which he demurs, and also those conclusions of fact which a jury may fairly draw from that testimony" and "the testimony is to be taken most strongly against him, and such conclusions as a jury might justifiably draw, the Court ought to draw." *Pawling v. United States*, 8 U.S. [4 Cranch] 219, 221-22 (1808).

The PSLRA's plain language directs the court to determine whether there is *a* strong inference for *plaintiff*; it says nothing about weighing competing inferences. Nor does it direct the district court to speculate, without factual basis, whether non-culpable explanations might exist, or to evaluate their strength.

This Court has held repeatedly that a statute should not be interpreted to effect a radical departure from the procedural regime under the Federal Rules unless Congress has made it clear a departure is required. *Jones v. Bock*, 127 S. Ct. 910, 921 (2007); *Hill v. McDonough*, 126 S. Ct. 2096, 2103 (2006); *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 512-14 (2002); *Leatherman v. Tarrant County Narcotic Intelligence & Coordination Unit*, 507 U.S. 163, 168-69 (1993). In *Jones*, this Court stated: "[W]e have explained that courts should generally not depart from the usual practice under the Federal Rules on the basis of perceived policy concerns. . . . [T]hat is a result which must be obtained by the process of amending the Federal Rules, and not by judicial interpretation." 127 S. Ct. at 919 (citation and internal quotation marks omitted).

[16] This Court assumes that Congress is "aware of existing law when it passes legislation." *Miles v. Apex Marine Corp.*, 498 U.S. 19, 32 (1990).

Petitioners argue that, because of certain policy considerations they believe override the goal of preserving meritorious private securities claims, this Court should add super-heightened pleading requirements not found in the PSLRA and jettison the firmly established methodology that governs motions to dismiss. That position should be rejected as it was in *Jones*.

If the Court deems the statutory text ambiguous as to the meaning of the words "strong inference," it is appropriate to see whether the legislative history throws any light on its proper interpretation. *Diamond v. Chakrabarty*, 447 U.S. 303, 315 (1980). Nothing in the legislative history suggests courts must depart from the long-standing procedures governing motions to dismiss. To the contrary, as discussed in Point I(D), below, the legislative history confirms that Congress rejected attempts to include language in the PSLRA that would have deprived plaintiffs of their historic entitlement to all reasonable inferences in their favor.

B. Petitioners' Interpretation Of "Strong Inference" Conflicts With Congress' Intent To Support And Encourage Meritorious Private Securities Fraud Claims

This Court should seek to effectuate all of the PSLRA's objectives. Petitioners stress only the termination of groundless claims. However, this Court should abjure such tunnel vision and protect the other PSLRA objective: private enforcement of our securities laws to promote their effectiveness.[17] The Conference Committee described the final legislation's purposes:

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[17] Several of petitioners' supporting *amici* take this opportunity to engage in thinly veiled attacks on some of the basic underpinnings of private enforcement actions, such as the existence of a private right of action to enforce § 10(b), universal acknowledgement by the circuit courts that scienter includes recklessness, and even the very concept of auditors' liability for securities fraud. None of these subjects is encompassed within the question presented by petitioners.

> The overriding purpose of our Nation's securities laws is to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans.... Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.

H.R. Rep. No. 104-369, at 59 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730,740.

This Court repeatedly has expressed its own belief that private securities fraud actions provide "a most effective weapon in the enforcement" of the securities laws and are a "necessary supplement to Commission action." *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). Justice Kennedy recognized in his dissenting opinion in *Lampf v. Gilbertson*, 501 U.S. 350, 374 (1991), that the private right of action under §10(b) "has become an essential component of the protection the law gives to investors who have been injured by unlawful practices." *See also Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 344 (2005) ("the securities statutes seek to maintain public confidence in the marketplace [citation omitted] ... by deterring fraud, in part, through the availability of private securities fraud actions").

According to the Conference Committee Statement of Managers, Congress sought "to increase the likelihood that institutional investors will serve as lead plaintiffs by requiring courts to presume that the member of the purported class with the largest financial stake in the relief sought is the 'most adequate plaintiff.'" Congress was motivated by its belief "that

increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." H.R. Rep. No. 104-369, at 61. By encouraging institutional investors to serve as class representatives and enacting other procedures designed to bring about responsible and vigorous class representation,[18] the PSLRA clearly sought to encourage well grounded securities fraud suits and to promote their effective prosecution.

Notwithstanding the vitriolic rhetoric of petitioners and supporting *amici*, the foundations of the republic are not about to crumble because defrauded investors seek relief from the companies that have cheated them. Indeed, the PSLRA's higher pleading requirements have led to dismissals nearly doubling. More than 38% of class action cases filed between 2000 and 2004 were dismissed,[19] and class action securities fraud filings "plunged to a record low" in 2006.[20]

Petitioners and supporting *amici* improperly present the Court with a hodge podge of articles, political diatribes, and self-serving commentary that does not provide a reliable factual record and that has nothing to do with the actual issue before the Court — interpreting the intent of Congress as reflected in the PSLRA. In effect, these presentations invite the Court to make economic policy and legislate, an invitation this Court should decline as being wholly inappropriate. Moreover,

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[18] 15 U.S.C. §78u-4(a)(3)(A)(i).

[19] Insurance Journal, *Federal Class Action Filings Plummet But Settlement Amounts Rise*, Feb. 21, 2007, *http://www.insurancejournal.com/news/national/2007/02/21/77078.htm*.

[20] *Securities Class Action Case Filings, 2006: A Year in Review*, Cornerstone Research (2007), at 1. *See also* Todd Foster, Richard I. Miller, Ph.D., Stephanie Plancich, Ph.D., *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar*, NERA Economic Consulting, Jan. 2007 ("NERA Study"), at 1, 2, 4.

regardless of whether or not the PSLRA as written has achieved all its objectives, this Court's role is to enforce the words that Congress actually enacted, not to draft new requirements not embodied in the statute.

Petitioners' supporting *amici* complain that since the passage of the PSLRA, the average settlement amount in actions that survive motions to dismiss has increased. However, the reason for that increase may well confirm the apparent effectiveness of private actions. Many recent recoveries reflect the fact that the securities fraud landscape post-PSLRA has been dominated by a series of multi-billion dollar, high profile securities frauds. Private securities actions addressing those frauds resulted, for example, in settlements in Enron ($7.1 billion), WorldCom ($6.1 billion), AOL Time Warner ($2.65 billion), Royal Ahold ($1.1 billion), Nortel ($2.2 billion), and McKesson HBOC ($960 million). *See* NERA Study at 5, 11. Significantly, neither petitioners nor supporting *amici* have put forth any evidence demonstrating that the higher average settlement amounts are the result of frivolous securities litigation.

Petitioners' supporting *amici* also claim that securities class actions and intensified government regulation are causing the United States to lose its competitive position in the global capital marketplace. The Court should be skeptical of such statements absent a complete factual record. Indeed, in contrast to the Bloomberg & Schumer report that petitioners' supporting *amici* so heavily rely upon, many facts offer a very different picture. According to a Fortune magazine article in response to that report:

> 56 companies backed by venture capitalists went public in 2006 in the United States, raising a total of $3.72 billion, the highest number and largest amount raised since 2004, the year of Google, according to Dow Jones VentureOne. More broadly, a Thomson Financial survey of all U.S. IPO activity shows that

> the 189 IPOs last year raised nearly $43 billion, more than the $41.4 billion raised by 558 deals in 1997. In other words, there were fewer but higher-quality deals. More are on the way.

Adam Lashinsky, *IPOS still love U.S. Markets*, Fortune, Feb. 1, 2007, *available at http://money.cnn.com/ 2007/01/30/* markets/pluggedin_lashinsky_markets.fortune/index.htm.[21]

A major objective of the PSLRA has been achieved in that many significant institutions have stepped forward and are lead plaintiffs in numerous private securities class actions. It was certainly not the intent of Congress to encourage their active participation while at the same time enacting a pleading standard that would unreasonably impair their ability to prosecute meritorious cases.

Despite all this evidence, petitioners and supporting *amici* propose unrealistic standards that would encourage the district courts to go well beyond what Congress intended and would result in the dismissal of many well-grounded lawsuits. This Court should not articulate a pleading standard that will prove impossible – even for meritorious actions – to satisfy. In *Lampf v. Gilbertson*, 501 U.S. at 376-77, Justice Kennedy (dissenting) noted: "the real burden on most investors, however, is the initial matter of discovering whether a violation of the securities laws occurred at all. This is particularly the case for victims of the classic fraud-like cases that often arise under § 10(b) …." *Id.* at 377. Given that difficulty, especially with respect to establishing a defendant's state of mind, it is highly questionable whether even the complaints that ultimately led to multi-billion dollar recoveries in admitted frauds such as Enron and Worldcom would have survived a motion to dismiss under the Kafkaesque

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[21] *See* Brief to be filed on behalf of the German Association for the Protection of Share Holders et al. as *amici curiae*, confirming that "private enforcement of United States securities laws, encourages rather than discourages foreign investors to invest and foreign companies to list in the U.S. markets." (Brief at 7)

super-heightened pleading standard proposed by petitioners and supporting *amici*.

C. The Strong Inference Provision Requires The Complaint To Support A Reasonable Conclusion That, More Likely Than Not, Petitioners Acted With Scienter

Statutory construction begins (and may well end) with the statute's language. *E.g.*, *Alexander v. Sandoval*, 532 U.S. 275, 288 (2001). Petitioners and supporting *amici* rely heavily on carefully selected aspects of dictionary definitions of "strong," completely ignoring other meanings and the signification of "inference." In *Virginia v. Black*, 538 U.S. 343, 395-96 (2003), Justice Thomas' dissenting opinion contains the following quoted definition (emphasis in original): "*An inference*, sometimes loosely referred to as a presumption of fact, *does not compel a specific conclusion. An inference merely applies to the rational potency or probative value of an evidentiary fact to which the fact finder may attach whatever force or weight it deems best.*"[22] According to Webster's Third International Dictionary (2002), "INFER indicates arriving at an opinion or coming to accept a *probability* on the basis of available evidence."

An inference would be "strong" if the particularized allegations support a reasonable conclusion that the defendant probably — *i.e.*, more likely than not — had scienter. For example, the American Heritage Dictionary of the English Language (4th ed. 2004) includes "persuasive" and "cogent" as definitions of a "strong argument." Neither of these definitions requires a strong inference to have a "high likelihood" of correctness (the Solicitor General's proposed standard) or mean that there can be no substantial possibility that the inference is incorrect (in effect proposed by both petitioners and the Solicitor

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[22] The quoted passage is from 9 J. Wigmore, Evidence in Trials at Common Law § 2491(1), at 304 (Chad. rev. 1981).

General). For example, according to Webster's Online Dictionary: "An argument is *cogent* if, and only if, supposing the premises all to be true, then the conclusion is *probably* (but not necessarily) true." http:// www.websters-online-dictionary.org/definition/strong. Webster's Third New International Dictionary defines "persuasive" as "tending to persuade." The statute's language therefore connotes probability and tendency, not "high likelihood" or any more extreme formulation.

Thus, facts that could convince a reasonable person that a defendant probably acted with scienter qualify as giving rise to a strong inference. The SAC sets forth facts that clearly meet that standard, as the Seventh Circuit properly concluded.[23]

D. Respondents' Interpretation Is Consistent With The Second Circuit Standard, Which The PSLRA Adopted

Congress clearly took the strong inference pleading standard from the Second Circuit case law, recognizing that the Second Circuit had set forth "the most stringent pleading standard" of any circuit.[24] *See* H.R. Rep. No. 104-369, at 66

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[23] In *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994), the Second Circuit specifically articulated the "more likely than not" formulation as plaintiff's pleading burden in a fraud action: "[S]ufficient facts were pleaded to suggest that plaintiffs may be able to prove that defendants *more likely than not* knew that their financial representations were false." *Id.* at 1174. At that time, the Second Circuit had already formulated the strong inference of scienter standard for application in fraud cases. *E.g.*, *Ross v. A. H. Robbins, Co.*, 607 F.2d 545, 558 (2d Cir. 1979). Although *Cohen v. Koenig* involved a common law fraud claim, the Second Circuit's "strong inference" pleading standard was not limited to federal securities law cases. Rather, it was that court's interpretation of Rule 9(b) as applied to fraud cases generally. *Cosmas v. Hasset*, 886 F.2d 8, 12-13 (2d Cir. 1989).

[24] *See Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000); *In re Advanta Corp. Secs. Litig.*, 180 F.3d 525, 533-34 (3d Cir. 1999).

(1995).[25] Nothing in the PSLRA's legislative history suggests that Congress meant to depart from the Second Circuit's express recognition that the strong inference test does not require or justify any departure from the well-settled rules that, on a motion to dismiss, the court must accept all factual allegations in the complaint as true and must draw all reasonable inferences in the plaintiff's favor.[26]

Indeed, Congress rejected a proposal, in H.R. 1058, that would have required plaintiffs to plead facts that "establish scienter" and would have denied plaintiffs the ability to plead "facts inconsistent" with a false statement to "establish scienter."[27] Petitioners and supporting *amici* effectively seek to resurrect the rejected language and supplant the long-standing rules governing motions to dismiss.

In 1998, Congress reaffirmed the PSLRA's intention to incorporate the Second Circuit standard. During its consideration of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which preempts securities class actions under state law and limits defrauded investors to their remedies under the federal securities laws, concern was expressed whether certain

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[25] The Statement of Managers mentions that, although the scienter provision was based in part on the Second Circuit pleading standard, "it does not intend to codify the Second Circuit's case law interpreting this pleading standard," explaining that, for this reason, "the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." *Id.* at 66 n.23. However, the legislative history contains no suggestion that the heightened pleading standard should not be applied consistent with the historic application by the Second Circuit and all other courts of the long-established rules that govern motions to dismiss.

[26] *E.g.*, *Rombach v. Chang*, 355 F.3d 164, 169 (2d Cir. 2004); *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001); *Citizens Utils., Co.*, 228 F.3d at 161; *Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1127 (2d Cir. 1994); *Cosmas*, 886 F.2d at 11.

[27] *See* H.R. Rep. No. 104-50(I), at § 10A(b)(1995).

courts had been misinterpreting the PSLRA by imposing pleading requirements that were more burdensome than the Second Circuit's test. Banking Committee Report, at S. Rep. No. 182, at 11 (1998). The Conference Report on SLUSA reconfirmed that the PSLRA was intended to incorporate the Second Circuit pleading standard: "[I]t was the intent of Congress . . . *that the Reform Act establish a heightened uniform federal standard on pleading requirements, based upon the pleading standard applied by the Second Circuit Court of Appeals.*" H.R. Rep. No. 105-803 ("1998 Conf. Rep."), at 13-15 (1998), *as reprinted in*, 1995 U.S.C.C.A.N. 730. If there is any uncertainty or obscurity about the intent of Congress, its clear expression on this issue in 1998 is entitled to "significant weight." *Seatrain Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. 572, 596 (1980).

Over the last decade, the SEC repeatedly has taken the position in *amicus* briefs that Congress adopted the Second Circuit's pleading standard. The SEC has never before supported a "high likelihood" standard or a weighing of competing inferences. *See Amicus* Brief to be filed on behalf of the Amalgamated Bank, as Trustee, pp. 18-23 and Appendix thereto. In the Solicitor General's brief, the SEC has now done a remarkable about face. This Court has made clear it will accord "no special weight" to the views of the SEC when it presents a position that flatly contradicts the views it previously and persistently expressed. *See, e.g., Int'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 566-67 (1979); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 858 n. 25 (1975).

Even though the Second Circuit did not allow weighing of competing inferences or speculation as to possible exculpatory explanations, its standard constituted a difficult hurdle for plaintiffs. As the Solicitor General's brief recognizes, applying its strong inference standard, "the Second Circuit required the dismissal of numerous securities fraud complaints." (Brief at 14) (citations omitted). If this Court heightens the barrier even more, beyond what Congress intended, it will be exceedingly difficult to prosecute even highly meritorious securities actions.

Indeed, one empirical study suggests the PSLRA has discouraged meritorious litigation.[28]

E. Most Courts Applying The PSLRA Do Not Weigh Competing Inferences Or Speculate As To Non-Culpable Explanations

In assessing a complaint under the PSLRA, most circuits, including the Seventh Circuit, examine all the complaint's allegations to determine whether a strong inference of scienter exists, but do not limit themselves to the most plausible or strongest inference the complaint supports.[29] The appropriate decisional process was aptly described by the Tenth Circuit in *Pirraglia v. Novell*, 339 F.3d 1182, 1187-88 (10th Cir. 2003) (citations omitted):

> Our role at the 12(b)(6) stage is simply to determine whether the plaintiff raises a strong inference of scienter. *We emphasize that this process does not involve a "weighing" of the plaintiff's suggested inference against other inferences. Faced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the factfinder.* Thus, we reject the position of the Sixth Circuit that "plaintiffs are entitled only to the most plausible of

[28] Eric Talley & Gudrun Johnsen, Corporate Governance, Executive Compensation and Securities Litigation 25 (Univ. of S. Cal. Law Sch., Olin Research Paper No. 04-7, 2004), *available at* http://econpapers.repec.org/paper/bepusclwp/usclwps-1002.htm

[29] *E.g.*, *Makor Issues & Rights v. Tellabs, Inc.* (Pet. App. at 19a-20a); *Phillips v. Scientific-Atlantic, Inc.*, 374 F.3d 1015, 1017 (11th Cir. 2004); *In re Alpharma Sec. Litig.*, 372 F.3d 137, 151 (3d Cir. 2004); *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003); *Adams v. Kinder-Morgan Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003); *Goldstein v. MCI Worldcom*, 340 F.3d 238, 246 (5th Cir. 2003); *In re K-Tel Int'l Sec. Litig.*, 300 F.3d 881, 889 (8th Cir. 2002).

> competing inferences." If a plaintiff pleads facts with particularity that, in the overall context of the pleadings, including potentially negative inferences, give rise to a strong inference of scienter, the scienter requirement of the Reform Act is satisfied.

Likewise, most other courts of appeal do not weigh inferences adverse to plaintiffs on motions to dismiss. *See, e.g., Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1264 (11th Cir. 2006); *In re PEC Solutions, Inc. Secs. Litig.*, 418 F.3d 379, 387 (4th Cir. 2005); *Rombach*, 355 F.3d at 169; *In re Rockefeller Center*, 311 F.3d at 205-06, 224; *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 406-07, 424-25 (5th Cir. 2001).[30]

Although the Sixth Circuit has held that a strong inference is only the "most plausible" of competing inferences (*Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc)), that court has qualified this approach, stressing: "When an allegation is capable of more than one inference, it must be construed in the plaintiff's favor. Our willingness to draw inferences in the favor of the plaintiff remains unchanged by the PSLRA." 251 F.3d at 553 (citation omitted). Subsequently, the Sixth Circuit expressed concern that, "for cases where a juror could conclude that the facts pleaded showed scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented." *City of Monroe Employees Retirement Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005).

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[30] On at least two recent occasions involving PSLRA motions to dismiss, the First Circuit criticized the district court for failing to give the plaintiff the benefit of all reasonable inferences, and for concluding instead that conflicting allegations undermined the sufficiency of the claim. *See In re Stone & Webster, Inc. Secs. Litig.*, 414 F.3d 187, 200 n.8 (1st Cir. 2005); *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 78 (1st Cir. 2002).

Although petitioners cite decisions in which, they argue, courts weighed competing inferences, in many instances the court actually was determining that there was no reasonable basis to draw any inference for plaintiff in the first place.[31] Obviously, the *weighing* process cannot begin unless the particularized allegations are sufficient to support an inference for plaintiff.

F. This Court Should Articulate A Standard Consistent With Its Rulings Concerning Dispositive Motions That Seek To Withdraw Factual Issues From The Jury

The Court should confirm a PSLRA pleading standard that embodies the same principles it has established for summary judgment and other dispositive motions. In *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986), this Court held that "the inquiry involved in a ruling on a motion for summary judgment or for a directed verdict necessarily implicates the substantive evidentiary standard of proof that would apply at the trial on the merits." 477 U.S. at 252. Thus, if plaintiff's burden at trial is to prove his or her case by a "preponderance of the evidence," a summary judgment motion "unavoidably asks whether reasonable jurors could find by a preponderance of the evidence" for the plaintiff. *Id.* The Court further held that, when plaintiff has a heightened burden of proof, plaintiff's ability to survive summary judgment — *i.e.*, the question whether plaintiff had sufficient evidence to demonstrate a genuine issue for trial —

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[31] For example, in *Gompper v. VISX, Inc.*, 298 F.3d 893, 896 (9th Cir. 2002), the Ninth Circuit recognized that on a motion to dismiss the reviewing court must accept the plaintiffs' allegations as true "and construe them in the light most favorable to the plaintiff," but cited the Sixth Circuit's *Helwig* decision for the statement that the strong inference requirement entitles plaintiffs to "only the most plausible of competing inferences." *Id.* at 897. *Gompper* itself did not actually weigh competing inferences. Rather, in substance, it held that plaintiffs had failed to plead facts that supported *any* inferences for them. *Id.* at 896-97.

would be measured in light of that higher standard. *Id.* at 255. Even so, this Court stated:

> Credibility determinations, the weighing of evidence, and the drawing of legitimate inferences from the facts are jury functions, not those of a judge, whether he is ruling on a motion for summary judgment or for a directed verdict. The evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his favor.

Id.

Respondents' ability to withstand the motion to dismiss and present their case on its merits should be measured in a manner comparable to the test faced by the plaintiff in *Liberty Lobby*. Just as the plaintiff in *Liberty Lobby* was entitled to all reasonable inferences, without any weighing of competing inferences, despite the heightened standard of proof, so too respondents should have the benefit of all reasonable inferences without any weighing of competing inferences. There is no reason for the standard on a motion to dismiss to be more burdensome for the plaintiff than the standard on a summary judgment motion, especially since the plaintiff has the benefit of discovery before it responds to the latter, but not when a PSLRA plaintiff responds to the former.

Precisely the same analogy exists — perhaps with even more force — between motions to dismiss for lack of scienter under the PSLRA and motions for judgment as a matter of law after trial. In *Reeves v. Sanderson Plumbing Prods., Inc.*, 530 U.S. 133, 150 (2000), this Court held that after reviewing all the evidence presented at trial, the district court "must draw all reasonable inferences in favor of the nonmoving party" and "must disregard evidence favorable to the moving party that the jury is not required to believe." *Id.* at 150-51.

Even without regard to the Seventh Amendment issue, discussed in Point II, below, as this Court noted in *Swierkiewicz*, 534 U.S. at 511: "It thus seems incongruous to require a plaintiff,

in order to survive a motion to dismiss, to plead more facts than he may ultimately need to prove to succeed on the merits. . . ." This comment by the Court is very much on point. The principal thrust of petitioners' position is to require respondents to plead far more than they would need to be allowed to present their case and possibly prevail at trial, in order to avoid dismissal.

G. The Seventh Circuit Decision Properly Implements The PSLRA's Heightened Pleading Standard

The decision below gives full effect to Congress' intent to raise the pleading standard. The Seventh Circuit did not rule that district courts should ignore complaint allegations that might provide support for defendants, and did not articulate a pleading standard that requires only a "reasonable" (rather than "strong") inference. After quoting the statute's strong inference pleading standard, the Seventh Circuit concluded that courts should "examine all of the allegations of the complaint and then ... decide whether collectively they establish such an inference." (Pet. App. 19a-20a)

In their desire to denigrate the work product of the court below, petitioners and supporting *amici* ignore the context and intent of the Seventh Circuit's statement that "we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." (Pet. App. 20a). At this point in its opinion, the Seventh Circuit was stating its rationale for disagreeing with the Sixth Circuit as to whether district courts should weigh conflicting inferences. Consistent with the approach to dispositive motions taken in *Liberty Lobby* and *Reeves*, the Seventh Circuit expressed its concern, quoting *Pirraglia*, 339 F.3d at 1188, that if a reasonable juror could find for the plaintiff, it would invade the province of the jury for the court to weigh other competing inferences to see which is stronger. (Pet. App. 20a-21a)

Petitioners and supporting *amici* are simply wrong in arguing that the Seventh Circuit standard would return the courts

to pre-PSLRA standards.[32] The standard that court adopted and respondents advocate significantly intensifies the district court's scrutiny on a motion to dismiss. The operative inquiry under Rule 12(b)(6) is simply whether plaintiff has stated a legally cognizable claim for relief. As properly interpreted, the PSLRA and the Seventh Circuit's construction of it require the court to go further and find the case strong enough to warrant its submission at trial to the fact finder.

Petitioners and supporting *amici* not only unfairly misdescribe the Seventh Circuit's actual methodology and decision, but also overlook the many other PSLRA provisions that have rendered the prosecution of private securities actions even more difficult.[33]

H. Petitioners Would Require District Courts To Make Premature Factual Determinations And To Weigh Hypothetical Defenses Without A Proper Evidentiary Record

The Solicitor General argues that the district court should consider whether the allegations leave open "non-culpable explanations" of defendants' conduct, and should dismiss if the allegations allow any "substantial possibility" that the defendants might not have acted with scienter. Similarly, petitioners argue that district courts should penalize plaintiffs if they omit details

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[32] Petitioners and supporting *amici* conveniently ignore that the Seventh Circuit held respondents to a high standard and affirmed dismissal of their § 10(b) claim against Michael Birck, Tellabs' Chairman, for failure to plead scienter adequately. (Pet. App. 23-24a)

[33] In addition to the strong inference requirement, the PSLRA heightened the requirement for pleading fraud so that state of mind, and not merely falsity, must be alleged with "particularity." 15 U.S.C. §78u-4(b)(1)(B). Plaintiffs also have to plead with particularity their factual basis for allegations proffered on information and belief. *Id.* Plaintiffs are automatically precluded from conducting discovery until the court resolves motions to dismiss — a further change from the pre-PSLRA approach taken by many courts, 15 U.S.C. §78u-4(b)(3)(B) – and are subject to mandatory sanctions in certain situations.

that would clarify whether defendants' conduct was either innocent or culpable. (Pet. Br. at 38) Such proposals would require dismissal unless plaintiff pleaded in such all-encompassing evidentiary detail as to foreclose any substantial possibility that valid defenses exist. There is no rational or reasonable justification or precedent for this hyper-elevated pleading standard.

The unprecedented standards proposed by petitioners and supporting *amici* conflict with the established principle that the complaint need not – indeed, should not – plead detailed evidence.[34] It also severely penalizes plaintiffs for not yet knowing information that, in a securities fraud action, typically is within the exclusive possession of defendants prior to discovery. Many cases properly hold that securities fraud plaintiffs need not plead such information as long as the complaint alleges facts that support the reasonableness of scienter allegations made on information and belief. *E.g.*, *Rombach*, 355 F.3d at 175 n.10; *In re Rockefeller Center*, 311 F.3d at 216; *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 351 (5th Cir. 2002).

Motions to dismiss are decided based only on the complaint's allegations, documents incorporated by reference in the complaint, and matters as to which the court may take judicial notice. 5B Charles A. Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1357 (3d ed. 2004). Therefore, any judicial surmise concerning possible exculpatory information would occur without any factual record. How, for example, is a district judge looking at a complaint to know whether it contains the fanciful "strategic ambiguity" complained of by petitioners (Pet. Br. at 38-39) if the judge lacks a factual record to show what information was left out? Resorting to information that historically has not been considered on a motion to dismiss would conflict with the

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[34] *E.g.*, *Conley*, 355 U.S. at 47; *Ottmann*, 353 F.3d at 350 n.8; *In re Cabletron Sys.*, 311 F.3d 11, 33 (1st Cir. 2002).

language of the PSLRA itself, which requires only that "the complaint" state facts giving rise to a strong inference of scienter. Speculation in the absence of a proper factual record should not deprive plaintiff of favorable inferences he or she otherwise would receive. Petitioners' approach would foster subjective and disparate rulings on motions to dismiss across the country, undermining the PSLRA's express purpose to promote uniform application of the securities laws. *See, e.g.*, H.R. Rep. No. 104-369, at 41; *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001).

Petitioners' disparagement of the complaint in this action highlights their true objective, which is to terminate securities cases regardless of their merit. For example, despite highly particularized factual allegations, based on investigation and numerous sources, showing petitioners made deceptive statements that plainly were at odds with what they knew about the serious problems clouding Tellabs' prospects, petitioners argue that respondents did not plead such evidentiary details as the precise dates of reports — facts that respondents could not rationally be expected to obtain until after discovery. Even if the information were available, petitioners are demanding a level of evidentiary detail not required at the pleading stage since the days of common law procedure.

As another example, petitioners contend that the court below should have rejected any inference for respondents because petitioners made certain disclosures in which they modified their guidance. The complaint's particularized allegations showed that those disclosures were themselves incomplete and deceptive. Moreover, there is no factual record on which the district judge could reach any informed conclusion as to why the modified guidance on which petitioners rely was given or what impact that guidance should have on the scienter issue.[35]

[35] Even without regard to Notebaert's scienter, the complaint adequately alleges knowledge on the part of many other members of (Cont'd)

Similarly, petitioners and supporting *amici* seek to raise the pleading standard to unreasonable heights by suggesting that, absent allegations of motive to engage in fraud, there can be no strong inference of scienter. Courts have recognized repeatedly that proof of motive is not necessary for § 10(b) liability. *See, e.g., In re HealthCare Compare Corp. Secs. Litig.*, 75 F.3d 276, 283 (7th Cir. 1996); *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1320 (5th Cir. 1977); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 362 (2d Cir. 1973).[36]

Petitioners' reliance on this Court's decisions in *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986), and *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984), is misplaced. In both cases, the courts had the benefit of a very full factual record. Indeed, in *Monsanto*, this Court

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Tellabs senior management, whose state of mind would be imputed to Tellabs for § 10(b) purposes. There is no requirement that the person with culpable knowledge be a named defendant. *See, e.g., City of Monroe Employees Retirement Sys. v. Bridgestone Corp.*, 387 F.3d 468, 508 & n.35 (6th Cir. 2004).

[36] Petitioners' suggestion that Notebaert had no incentive to misrepresent Tellabs' performance and prospects defies common sense. The public revelation that its most important product, 5500, was not selling and that one of its most important new products, 6500, was not ready surely would have jeopardized the Company's standing in a highly competitive and troubled market. That Notebaert, whose livelihood and business reputation depended on his Company's success, desired to protect Tellabs and himself from the adverse effects of publicizing those problems makes complete sense. A jury also might consider that the Company's Chairman and five other insiders personally profited from the artificial inflation of Tellabs stock by selling, during the Class Period, almost 150,000 shares for proceeds of over $8 million. (JA 148-52, ¶¶144-45) None of the insiders *purchased* any Tellabs stock during the Class Period (other than certain options exercised at substantially below-market prices, that were then immediately sold for a substantial profit). (JA 148-52, ¶¶144-45) No inference adverse to respondents should be drawn from the fact that Notebaert did not risk his reputation, property, or liberty by not engaging in illegal selling of Tellabs stock.

upheld the jury verdict as reasonable even though some of the plaintiff's evidence was "ambiguous." 465 U.S. at 765-66.

Matsushita is consistent with a proscription against weighing. In that case, this Court considered the propriety of granting summary judgment on an antitrust claim alleging a predatory pricing conspiracy. The evidence offered by plaintiffs suggested either a conspiracy that would result in higher, not lower, prices, or conduct as consistent with legitimate price competition as with unlawful behavior. 475 U.S. at 594. Thus, *Matsushita*, far from condoning a weighing of inferences, concluded that summary judgment was appropriate because "the conduct does not give rise to [any] inference of conspiracy." *Id.* at 596-97.[37] Ultimately, this Court concluded there were no reasonable inferences to be drawn in plaintiffs' favor, not that any such inferences were outweighed by inferences favoring defendants.[38] That understanding of *Matsushita* was clarified

[37] Moreover, central to the *Matsushita* decision was a concern that price-cutting to increase business could be pro-competitive, yet prone to be misconstrued as collusive. 475 U.S. at 593-94.

[38] *Pennsylvania R.R. Co. v. Chamberlain*, 288 U.S. 333 (1933), a FELA action, and *Gunning v. Cooley*, 281 U.S. 90 (1930), relied upon by amicus New England Legal Foundation, are consistent with *Matsushita* in that when evidence indicates wrongful behavior and perfectly lawful behavior in equal measure, it is not on its own probative. As explained in *Liberty Lobby*, 477 U.S. at 251, insufficient evidence supported a jury's finding in the *Chamberlain* plaintiff's favor. *Chamberlain*'s precedential value may have been compromised by later cases such as *Lavender v. Kurn*, 327 U.S. 645, 653 (1946), which recognized that "a measure of speculation and conjecture" by the jury may be necessary to choose "the most reasonable inference" from the evidence presented. "Only when there is a complete absence of probative facts to support the conclusion reached does a reversible error appear." *Id.* at 653. *See, e.g., Preston v. Safeway Stores, Inc.*, 163 F. Supp. 749, 752-53 (D.D.C. 1958) (noting that *Lavender* overruled *Chamberlain* "*sub silentio*"), *aff'd*, 269 F.2d 781 (D.C. Cir. 1959). In *Gunning*, the Court confirmed: "[w]here uncertainty as to the existence of negligence

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in *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992), in which this Court explained: "*Matsushita* demands only that the nonmoving party's inferences be reasonable in order to reach the jury, a requirement that was not invented, but merely articulated, in that decision. If the plaintiff's theory is economically senseless, no reasonable jury could find in its favor, and summary judgment should be granted."[39]

The PSLRA did not create a regime requiring plaintiffs to prove their case on the face of the complaint.[40] That would be contrary to Congress' express commitment to protecting shareholders and the integrity of the securities markets. Requiring courts to speculate as to how much weight competing strong inferences should be given — in the face of a legitimate inference for the plaintiff — does just that and is likely to result in dismissal of many meritorious fraud claims: "In this era of corporate scandal . . . we are cautious to raise the bar of the PSLRA any higher than that which is required under its mandates. The District Court's failure to accept Plaintiffs' allegations as true and construe them in the light most favorable to Plaintiffs does just that." *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 946 (9th Cir. 2003).

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arises from a conflict in the testimony or because, the facts being undisputed, fair-minded men will honestly draw different conclusions from them, the question is not one of law but of fact to be settled by the jury." 281 U.S. at 94.

[39] In *Eastman Kodak*, this Court ignored inferences raised by the moving party favorable to it on summary judgment, 504 U.S. at 486; instead it framed its examination of the record solely in terms of the reasonableness of the non-moving party's inferences. *Id.* at 471 ("[d]oes Kodak's theory describe actual market behavior so accurately that respondents' assertion of Kodak market power in the aftermarkets, if not impossible, is at least unreasonable?"). Because those inferences were not unreasonable, summary judgment was denied. *Id.* at 477.

[40] "The PSLRA did not . . . purport to move up the trial to the pleadings stage." *Kinder-Morgan*, 340 F.3d at 1101.

II. THE UNPRECEDENTED AND INCONSISTENT STANDARDS OF STRONG INFERENCE URGED BY PETITIONERS AND SUPPORTING *AMICI* CONTRAVENE THE SEVENTH AMENDMENT

Any interpretation of the PSLRA's strong inference standard requiring more than an inference strong enough to support a reasonable jury's finding that defendant acted with scienter violates the jury trial guarantee.[41] Respondents' proposed pleading standard is consistent with the proof standard plaintiffs must satisfy at trial as well as with the Seventh Amendment standard this Court has articulated as to when a fact issue properly can be withdrawn from the jury.

In *Herman & Maclean v. Huddleston*, 459 U.S. 375 (1983), this Court held that preponderance of the evidence is the governing proof standard in cases under § 10(b). *Id.* at 390. If the PSLRA pleading requirement places a higher burden on plaintiffs than preponderance, a district court would have to dismiss a complaint even though its allegations, if proved, would be sufficient for a jury to find for the plaintiff. This result is likely to occur if the Court adopted the Solicitor General's "high likelihood" standard, which clearly raises the pleading bar higher than preponderance. Similarly, petitioners' conveniently constructed notion that the complaint must be one that "meaningfully tends to exclude innocent possibilities," and that the complaint should be dismissed if it "leaves out details that would clarify whether the identified conduct was either innocent

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[41] Because respondents offer a construction of "strong inference" that avoids this constitutional problem, this construction should be adopted by this Court. *Curtis v. Loether*, 415 U.S. 189, 192 n.6 (1974). This argument is properly before the Court because, as the Seventh Circuit recognized, Seventh Amendment concerns must be considered in interpreting the PSLRA "strong inference" standard. *See Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 379-80 (1995) (argument not waived, even though expressly disclaimed in the courts below, because the argument "is fairly embraced within the question set forth in the petition for certiorari").

or culpable" (Pet. Br. at 38) raises a substantial prospect that complaints would be dismissed even though their factual allegations might convince a reasonable jury applying a preponderance standard to find for plaintiff.

A. The Seventh Amendment Mandates The Substance Of The Jury Trial Be Preserved; The Jury Must Be Allowed To Be The Fact-Finder

This Court has long recognized: "Maintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with utmost care." *Dimick v. Schiedt*, 293 U.S. 474, 486-87 (1935) (Stone, J., dissenting). And, as then Justice Rehnquist wrote, dissenting, in *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 343-44 (1979), jury trial is "an important bulwark against tyranny and corruption, a safeguard too precious to be left to the whim of the sovereign," "not animated by a belief that use of juries would lead to more efficient judicial administration," but rather a belief that "juries represent the layman's common sense, the 'passional elements in our nature,' and thus keep the administration of law in accord with the wishes and feelings of the community. O. Holmes, Collected Legal Papers 237 (1920)." *Id.* at 343-44.

Analysis of whether a procedure violates the Seventh Amendment looks to whether that procedure obstructs or interferes with the jury's substantive role as fact-finder. *See Dimick*, 293 U.S. at 491 (Seventh Amendment forbids procedures that "curtail the function of the jury to decide questions of fact as it did before the adoption of the Amendment" (Stone, J., dissenting)).

Even when upholding procedural changes in jury trial practice, this Court has protected the fact-finding role of the jury. Thus, in *Ex parte Peterson*, 253 U.S. 300, 311 (1920), the Court approved the use of a court-appointed auditor to hold a hearing to determine issues in dispute, so long as "[t]he parties

will remain as free to call, examine, and cross-examine witnesses as if the report had not been made." The Court held that the Seventh Amendment "does not prohibit the introduction of new methods for determining what facts are actually in issue" so long as "the right of trial by jury be not obstructed, and ... the ultimate determination of issues of fact by the jury be not interfered with." *Id.* at 309-10. In *Gasoline Prods. Co. v. Champlin Refining Co.*, 283 U.S. 494, 500-01 (1931), the Court allowed a partial new trial even though at common law any new trial would be on all issues, because a partial new trial did not obstruct the jury's role as ultimate fact-finder. In *Baltimore & Carolina Line, Inc. v. Redman*, 295 U.S. 654, 659 (1935), the Court found a judgment notwithstanding the verdict to be constitutionally acceptable, so long as its use was limited to cases in which a party's evidence was legally insufficient to support a jury verdict in the nonmovant's favor. And in *Galloway v. United States*, 319 U.S. 372 (1943), in the course of upholding the directed verdict procedure, the Court recognized, "the Seventh Amendment. . . *guaranty requires that the jury be allowed to make reasonable inferences from facts proven in evidence having a reasonable tendency to sustain them.*" *Id.* at 395-96.[42] Again, as in *Peterson*, *Gasoline Prods.*, and *Redman*, the procedure in *Galloway* was found to be constitutional because it did not encroach upon the jury as ultimate fact-finder unless, as a matter of law, the non-moving party could not support its claim.

Thus, this Court always has recognized that a plaintiff's right to a jury on the facts can be limited only if "'the evidence, with all the inferences that justifiably could be drawn from it,

[42] The comment in *Galloway* that "[t]he jury was not absolute master of fact in 1791," 319 U.S. at 390, cited *Rex v. Paine*, 5 Mod. 163 (K.B. 1792), and *Folkes v. Chadd*, 3 Doug. 157 (K.B. 1782). That these cases do nothing more than apply evidentiary rules demonstrates that *Galloway*'s comment meant simply that the right to a jury trial must be considered in light of the rules of evidence, *not* that a court had wide latitude to substitute itself as fact-finder. *See Galloway*, 319 U.S. at 390 n.22.

does not constitute a sufficient basis for a verdict for the plaintiff . . . so that such a verdict, if returned, would have to be set aside.'" *Gunning*, 281 U.S. at 93-94 (citing cases). Only the jury can be the fact-finder unless a court concludes that as a matter of law there is only one possible jury determination. *See Baltimore & Ohio R.R. Co. v. Groeger*, 266 U.S. 521, 524 (1925).

The great respect this Court has accorded the jury trial guarantee was demonstrated in the seminal decisions in *Beacon Theatres, Inc. v. Westover*, 359 U.S. 500 (1959), *Dairy Queen, Inc. v. Wood*, 369 U.S. 469 (1962), and *Ross v. Bernhard*, 396 U.S. 531 (1970), by contracting the equity jurisdiction concepts of irreparable injury and inadequacy of the legal remedy and thereby dramatically expanding the issues that are constitutionally jury triable. And, not surprisingly, this philosophy has been incorporated into Federal Rule 50(a)(1) (directed verdict granted if "there is no evidentiary basis for a reasonable jury to find for [a] party on [an] issue"). *See* Fed. R. Civ. P. 50, Advisory Committee Notes on 1991 Amendments ("The expressed standard makes clear that action taken under the rule is a performance of the court's duty to assure enforcement of the controlling law *and is not an intrusion on any responsibility for factual determinations conferred on the jury by the Seventh Amendment or any other provision of federal law.*").

Liberty Lobby, 477 U.S. at 247-48, similarly applies this standard to Rule 56 motions, holding that disputes "over facts that might affect the outcome of the suit" "such that a reasonable jury could return a verdict for the nonmoving party" are inappropriate for summary judgment. Moreover, the Court confirmed that "[if] reasonable minds could differ as to the import of the evidence, however, a verdict should not be directed." *Id.* at 250-51.

B. The Jury Trial Right Applies To Actions Under § 10(b)

The Seventh Amendment applies to this action, which seeks damages to remedy violations of statutory rights analogous to common law claims tried to a jury in 1791, *i.e.* fraud. Statutory policies, such as "expedition," fear of jury bias, or a desire to screen out meritless or marginal cases, "are insufficient to overcome the clear command of the Seventh Amendment." *See Curtis v. Loether*, 415 U.S. at 198 (civil rights). Indeed, the Seventh Amendment applies and that "command" trumps even a statutory indication that Congress did not intend a jury trial right to attach to a particular matter. *City of Monterey v. Del Monte Dunes*, 526 U.S. 687 (1999) (42 U.S.C. § 1983 takings claim); *Feltner v. Columbia Pictures Television, Inc.*, 523 U.S. 340 (1998) (copyright); *Pernell v. Southall Realty*, 416 U.S. 363 (1974) (landlord-tenant). *See also* 9 Wright & Miller, Federal Practice & Procedure § 2302.2 (2d ed. Supp. 2006).

Congress' power to create, modify, or eliminate private rights of action under the Exchange Act does not empower Congress to impair the jury trial guarantee as long as those rights exist, *cf. Granfinanciera, S. A. v. Nordberg*, 492 U.S. 33, 52-53 (1989) (Congress may not assign fact-finding in private litigation to an administrative tribunal), as they do. Moreover, the preponderance proof burden for § 10(b) claims (*see Huddleston*) was not elevated by the PSLRA.[43] Thus whether petitioners' proposed pleading standard would be appropriate *had* Congress raised the standard of proof is hypothetical and irrelevant.[44]

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[43] *See Green Tree*, 270 F.3d at 654 n.7 (citing cases from nine courts of appeal). *Geffon v. Micrion Corp.*, 249 F.3d 29 (1st Cir. 2001), cited by the Solicitor General, is silent as to the standard of proof for scienter, and merely reaffirms that circuit's precedent that allegations of motive and opportunity do not alone suffice for a reasonable inference of scienter. *Id.* at 36.

[44] For the same reason, *amicus* Washington Legal Foundation's citation to *Liberty Lobby*, 477 U.S. at 252, 254-56, for the proposition

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The Solicitor General and petitioners' other supporting *amici* argue that the Seventh Amendment may apply at trial or on summary judgment, but not at the pleading stage. This argument seriously misreads their cited authorities. For example, the comment in *Scheuer*, 416 U.S. at 236, that "the issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support its claims" simply indicated that, consistent with *Conley v. Gibson*, 355 U.S. 41 (1957), a Rule 12(b)(6) motion merely tests whether the plaintiff has *stated* a cognizable right to relief. In the same paragraph of *Walker v. New Mexico Southern Pacific R.R. Co.*, 165 U.S. 593, 596 (1897), as the comment that the Seventh Amendment "does not attempt to regulate matters of pleading" is the statement: "[To preserve the substance of the Amendment] ... requires that questions of fact in common law actions shall be settled by a jury, and that the court shall not assume directly or indirectly to take from the jury or to itself such prerogative." The observation in *Galloway*, 319 U.S. at 390 n.22, that the Seventh Amendment does not "require adherence to the common-law system of pleading," cites the *Peterson*, *Gasoline Prods.*, and *Dimick* cases, as discussed in Point II(A), and *Walker* discussed above in this paragraph, none of which suggest that obstructing the jury's substantive role as fact-finder is permissible.[45] The observation in *Baltimore & Carolina Line, Inc. v. Redman*, 295 U.S. at 657, that "mere matters of form or procedure" are not affected by the Seventh Amendment's

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that "courts must take into account the legal rules and standards of proof governing the claims at issue, including any elevated standards imposed upon the party bearing the ultimate burden of proof at trial" (Brief at 17) has no bearing. Congress has not enacted any 'elevated standards" of proof.

[45] *Galloway* also cites *Capital Traction Co. v. Hof*, 174 U.S. 1 (1899), which merely holds that a civil action brought before a justice of the peace in the District of Columbia is triable by a jury, even though at common law such an action would not be jury triable. *Hof* thus protects the substantive role of the jury as fact-finder.

protections was conditioned on furthering the Amendment's "aim" that "issues of law are to be resolved by the court and issues of fact are to be determined by the jury under appropriate instructions by the court." The comment in *Pease v. Rathbun-Jones Engineering Co.*, 243 U.S. 273, 278 (1917), that "the constitutional right of trial by jury presents no obstacle" to granting summary judgment was based on a specific issue, having nothing to do with this case's Seventh Amendment inquiry, regarding the defendant surety's "acquiescence" to proceeding in equity on a damage claim against him.

Other than these disembodied comments,[46] petitioners and supporting *amici* offer no substantive basis for concluding that the respect for jury trials accorded on summary judgment and at trial should not apply with equal force on a motion attacking a PSLRA pleading, when the plaintiff has set forth sufficient facts to support a reasonable jury verdict in its favor or scienter. Indeed, should this Court accept petitioners' and supporting *amici*'s argument, it is difficult to imagine any articulable constitutional limit on what allegations or claims could be stricken on a motion to dismiss, no matter how meritorious a jury might find them as a matter of proof. If the district judge can make factual determinations or weigh the merits of allegations or competing inferences on a motion to dismiss, pleading motions may serve as an avenue for evading and ultimately eroding Seventh Amendment protections.

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[46] Finally, *amicus* Chamber of Commerce's reliance on 8 Moore's Federal Practice § 38.12 ignores that treatise's clarification at subsection [1] that "[a] great many procedural processes have the effect of limiting or even diminishing the jury's prerogatives, yet they have passed constitutional muster, and their use has been approved, *so long as the court adheres to the standards provided in the Rules and shaped by court decisions, limiting the power of the courts to invade the province of the jury.*"

C. Characterizing The PSLRA's Strong Inference Requirement As Merely A Heightened Pleading Standard Or A "Legal" Standard Does Not Immunize It From Seventh Amendment Scrutiny

Consistent with the Seventh Amendment, procedural rules or statutes may impose pleading standards that require heightened detail on the factual matters ultimately to be adjudicated at trial, as with Rule 9(b)[47] and the PSLRA itself, or the clarification of ambiguities,[48] as with Rule 12(e), particularly when the ambiguity suggests that the pleader's case might fail as a matter of law.[49] Likewise, rules requiring verification or certification of allegations by oath or otherwise, as with Rule 11, are acceptable to the extent they guard against frivolous claims.[50] Indeed, the authorities relied upon by petitioner and supporting *amici* (*see* notes 47 - 50) support dismissal only in

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[47] *See Swierkiewicz*, 534 U.S. at 512-13: *Leatherman*, 507 U.S. at 168. *See also Jones*, 127 S. Ct. at 921 (noting Congress' power to require particularized pleading of exhaustion of remedies, as failure to exhaust was grounds for substantive dismissal of claim).

[48] *See Fidelity & Deposit Co. v. United States*, 187 U.S. 315, 322 (1902) (defendant required, but failed, to state his defense "in precise and distinct terms") (citations omitted).

[49] *See Stuart v. United States*, 85 U.S. 84, 87-88 (1873) (claim dismissed when plaintiff was required to prove that Native Americans who stole his cattle were "enemies" of the United States but pled ambiguously that Native Americans were "hostile," without clarifying whether they were hostile to plaintiff specifically or hostile to the United States generally); *United States v. Linn*, 42 U.S. 104, 113-14 (1843) (defendant unsuccessfully tried to avoid liability on joint note by claiming that the note was altered after his signature; defendant failed to claim who altered it, that the obligee knew of the alteration, or that the defendant himself did not know that the note had been altered"); 1 Chitty & Chitty, *A Treatise on the Parties to Actions and on Pleading* 236 (6th ed. 1836) (case could be dismissed for failure to allege elements of claim adequately, even though plaintiff conceivably could win at trial with greater detail).

[50] *See Ex parte Peterson*, 253 U.S. at 311 (requiring plaintiff to take an oath as to his allegations).

these situations. That is far different from a construction of the strong inference requirement that demands more in the plaintiff's complaint than is needed to warrant the case's submission to the jury.

Petitioners and supporting *amici* cannot evade Seventh Amendment scrutiny by conclusorily characterizing the sufficiency of scienter allegations as legal, not factual. Whether a complaint presents enough to establish the requisite scienter inference is a factual matter based on an evaluation of what the pleading alleges actually happened. "At a minimum, the jury is master of 'historical' fact." Arthur R. Miller, *The Pretrial Rush to Judgment: Are The "Litigation Explosion," "Liability Crisis" and Efficiency Cliches Eroding Our Day in Courts and Jury Trial Commitments?*, 78 N.Y.U.L. Rev. 982, 1083 (2003). A determination of scienter involves a classic evaluation of the "mainsprings of human conduct," something this Court has referred to at least twice as appropriately within the jury's competence. *Markman v. Westview Instruments, Inc.*, 517 U.S. 370, 389 (1996) (quoting *Commissioner v. Duberstein*, 363 U.S. 278, 289 (1960)).

Unless a court concludes as a matter of law that no reasonable jury could find scienter by a preponderance of the evidence, the matter must be left to the jury. The more demanding pleading standards advanced by petitioners and supporting *amici* for a PSLRA motion to dismiss — effectively a dispositive motion — require the court to act as fact-finder on a merits issue in contravention of Seventh Amendment principles.[51]

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[51] Specifically, *amicus* Washington Legal Foundation states (Br. at 19) a complaint can be dismissed under the PSLRA if "legally insufficient under the governing standard," but the Foundation fails to recognize that the "governing standard" is the preponderance standard that has not been altered. In any event, characterization of the PSLRA strong inference determination as a question of law rather than a question of fact would lead to eradication of Seventh Amendment rights in a

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D. Weighing Inferences Is A Constitutionally Protected Jury Function

Petitioners propose that the PSLRA requires the court to "consider and weigh all the allegations of the complaint, along with all other materials properly before it, *including facts that support an inference of innocence*." (Pet. Br. at 17) But to be consistent with the jury trial guarantee, if plaintiffs have pleaded facts from which a jury reasonably could find fraudulent intent, all weighing must end.[52]

This Court has established in various contexts that a court must draw all inferences in favor of a party opposing a dispositive motion and it cannot determine "[i]ssues that depend on the credibility of witnesses, [or] the effect or weight of evidence." *Gunning*, 281 U.S. at 94. *See also Galloway*, 319 U.S. at 396 ("[The Seventh Amendment's] guaranty requires that the jury be allowed to make reasonable inferences from facts proven in evidence having a reasonable tendency to sustain them."). *Tennant v. Peoria & Pekin Union Railway Co.*, 321 U.S. 29, 35 (1944), is in accord:

> It is not the function of a court to search the record for conflicting circumstantial evidence in order to take the case away from the jury on a theory that the proof gives equal support to inconsistent and uncertain inferences. The focal point of judicial review is the reasonableness of the particular

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wide range of substantive areas, by inviting the enactment of "legal" standards that could prevent meritorious claims or defenses from reaching a jury. *Cf. Granfinanciera.*

[52] Petitioners' supporting *amici* articulate standards that transgress the Seventh Amendment, by proposing formulations that improperly would require a court to consider inferences unfavorable to the plaintiff, weigh them against legitimate inferences for the plaintiff, and dismiss the complaint if the court believes the inference for defendant is more persuasive even if the inferences favoring plaintiff reasonably could support a jury's verdict for it.

> inference or conclusion drawn by the jury. It is the jury, not the court, which is the fact-finding body. . . . The very essence of its function is to select from among conflicting inferences and conclusions that which it considers most reasonable.

These principles were reaffirmed in *Liberty Lobby*, 477 U.S. at 255, and *Reeves*, 530 U.S. at 150-51, discussed in Point I(F). Also, as discussed in Point I(H), *Matsushita* is consistent with these authorities and provides no support for petitioners and supporting *amici*.

CONCLUSION

For the foregoing reasons, the decision of the court of appeals should be affirmed.

Respectfully submitted,

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